**Movants' HTA Exhibit 123**

# Governmental Accounting, Auditing, and Financial Reporting

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The independent auditors are responsible for the opinion they express concerning the fair presentation of the financial statements. Their responsibility in that regard, however, in no way diminishes either management's primary responsibility or the governing body's ultimate responsibility for the government's financial reporting.

## Chapter in brief

Accounting, financial reporting, and the financial statement audit provide the informational infrastructure of public finance.

*Accounting* and *financial reporting* are complementary rather than identical.

- *Accounting* is the process of assembling, analyzing, classifying, and recording data relevant to transactions and events that affect the government's finances.
- *Financial reporting* is the process of taking the information thus assembled, analyzed, classified, and recorded and providing it in usable form to those who need it.

Both accounting and financial reporting are primarily the responsibility of management.

Financial reporting can take one of three forms: *internal financial reporting, special purpose external financial reporting*, and *general purpose external financial reporting*.

The content, format, and timing of internal financial reports are set by management. Typically data in those reports are presented in a manner consistent with the budget. 33

The content, format, and timing of special purpose external financial reports are set by outside parties (a state regulatory agency or grantor).

General purpose external financial reporting is designed to serve a broad range of potential users and typically is governed by GAAP, which may not be consistent with budgeting.

Information in general purpose external financial reporting can be communicated in one of three ways: *display* (inclusion in one of the basic financial statements), *disclosure* (inclusion in the notes to the basic financial statements), or *supporting information*.

Items are displayed in the financial statements only if they meet the definition of one of the seven financial statement elements *(assets, liabilities, inflows of resources, outflows of resources, deferred inflows of resources, deferred outflows of resources*, and *net position*) and can also be reliably measured.

Disclosure is used for *descriptions* of the policy underlying amounts presented in the basic financial statements, *detail or explanations* concerning amounts presented in the basic financial statements, and *information about potential financial statement elements* that do *not* qualify for recognition.

Supporting information is designed to provide *operational, economic, or historical context*. Sometimes the presentation of supporting information is mandated, in which case it is referred to as *required supplementary information*.

Accounting data must possess certain essential characteristics for inclusion in general purpose external financial reporting: *understandability, reliability, relevance, timeliness, consistency*, and *comparability*.

The financial statement audit is designed to provide independent assurance that the financial statements are fairly presented.

A comprehensive framework of internal control is necessary to provide management a reasonable basis for assuming responsibility for the financial statements.

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# Funds, Fund Types, and Interfund Activity

Of all of the traits that distinguish accounting and financial reporting for state and local governments from accounting and financial reporting for businesses, perhaps the most obvious is fund accounting. This chapter will examine the crucial role that funds play in the public sector. It also will consider the appropriate accounting and financial reporting for activity between funds.

## Nature and purpose of fund accounting

In the private sector, managers typically enjoy considerable discretion in how they apply financial resources to achieve an entity's objectives. They ultimately are accountable to their governing body (board of directors), of course, but mainly *after the fact*. Public-sector managers, in contrast, find themselves in a quite different position.

First, state and local governments often receive financial assistance from higher levels of government. In most cases, those resources must be used for purposes specified by the provider. That is, management's discretion on how to use the resources is *preempted*, to a large degree, by the resource provider. Management, for instance, could not redirect grant proceeds destined for low-income housing to finance infrastructure maintenance, even if management believed the money would be better spent on infrastructure than on housing.

Second, the legislative branch (governing body) exercises the "power of the purse" over the executive branch (management). Management needs the authorization of the governing body to raise and spend public money. This authorization normally takes the form of an annual (or biennial) appropriated budget, which legally limits the types of revenues that may be raised and how budgeted resources may be spent. Once again, management's discretion is *preempted* to a large extent, this time by the governing body. If resources were budgeted for equipment, for instance, a government's management normally would not legally be able to spend them instead on salaries. Likewise, resources budgeted for one department (police) often could not legally be spent for another (parks and recreation). Thus, there are significant constraints on how managers spend even a government's own-source revenues.

The first principal of accounting and financial reporting for state and local governments (Accounting and Reporting Capabilities) states that:

> A governmental accounting system must make it possible both: (a) to present fairly and with full disclosure the funds and activities of the governmental unit in conformity with generally accepted accounting principles, and (b) to determine and demonstrate compliance with finance-related legal and contractual provisions.[1]

Given the special compliance challenges of the public sector described earlier, state and local governments need some reliable yet practical means of determining and demonstrating "compliance with finance-related legal and contractual provisions." For almost a century, fund accounting has met that need. Thus, the second principle of governmental accounting and financial reporting for state and local governments (Fund Accounting Systems) states that "governmental accounting systems should be organized and operated on a fund basis." That principle goes on to define a *fund* as:

> a fiscal and accounting entity with a self-balancing set of accounts recording cash and other financial resources, together with all related liabilities and residual equities or balances, and changes therein, which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions, or limitations.[2]

For example, a government might establish a separate *fund* to account for revenues from gasoline taxes that can only be spent on road repair and construction so as to ensure and demonstrate compliance with that requirement. Such a fund also might assist financial statement users with a particular interest in resources available for road repair and construction.

At the inception of fund accounting, individual funds most often corresponded to separate bank accounts. Since that time, advances in treasury management have reduced or eliminated the need for multiple bank accounts. Accordingly, today's funds may exist only as data sets within the government's information system.

## Number of Funds principle

The third principle of governmental accounting and financial reporting for state and local governments (Number of Funds) states that:

> Governmental units should establish and maintain those funds required by law and sound financial administration. Only the minimum number of funds consistent with legal and operating requirements should be established, however, since unnecessary funds result in inflexibility, undue complexity, and inefficient financial administration.[3]

As explained previously,[4] it is important to distinguish *accounting* (collection and maintenance of detailed financial data) from *financial reporting* (aggregation of detailed data from the accounting system into a form suitable for decision making).

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1. National Council on Governmental Accounting (NCGA) Statement 1, *Governmental Accounting and Financial Reporting Principles*, Principle 1. This definition was written essentially from the perspective of governmental funds. Proprietary funds and trust funds report capital assets as well, even though capital assets are not mentioned in this definition.
2. NCGA Statement 1, Principle 2.
3. NCGA Statement 1, Principle 3.
4. See Chapter 1.

**EXHIBIT 4-1** Fund categories

| | |
|---|---|
| Governmental funds | Used to account for activities primarily supported by *taxes, grants, and similar revenue sources* |
| Proprietary funds | Used to account for activities that receive significant support from *fees and charges* |
| Fiduciary funds | Used to account for resources that a government holds as a trustee or agent on behalf of an outside party that *cannot be used to support the government's own programs* |

The number of funds necessary for *accounting* purposes (high level of detail) may be greater than the number of funds needed for *financial reporting* purposes (lower level of detail). Accordingly, the practical application of the Number of Funds principle often involves treating two or more of the funds used for accounting purposes as a single fund for financial reporting purposes.[5]

## Fund categories

Financial activities for state and local governments fall into three broad categories. Some activities are financed through taxes, grants, and similar nonexchange revenues (general government). Other public-sector activities rely to a significant degree on fees and charges and operate more like a business (utilities). In still other cases, the government may serve as a trustee or agent on behalf of one or more outside parties (pension plan). Accordingly, there are three broad categories of funds (see Exhibit 4-1):

- *Governmental funds* are used to account for activities primarily supported by taxes, grants, and similar revenue sources;
- *Proprietary funds* are used to account for activities that receive significant support from fees and charges; and
- *Fiduciary funds* are used to account for resources that a government holds as a trustee or agent on behalf of an outside party and that *cannot* be used to support the government's own programs.[6]

## Fund types

Within each of the three broad categories just described, individual funds are further categorized by *fund type*.

5. There are a number of practical steps a typical government can take to reduce the number of individual funds that it presents in its financial reports: 1) consider combining numerous smaller debt service "funds" into a single fund; consider combining numerous smaller capital project "funds" into a single fund; consider combining grants for similar purposes into a single special revenue fund; and consider using internal service funds only when necessary to support the assessment of charges on an accrual basis. All the same, separate funds must be reported for individual external investment pools and individual postemployment benefit plans. See the Government Finance Officers Association's best practice on "Improving the Effectiveness of Fund Accounting" (2004).
6. Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, paragraph 69.

**Categories of control-related policies and procedures.** Many different variants of control-related policies and procedures can be found in practice. Virtually all of them can be classified into one of the following categories:

- Procedures to ensure that transactions are properly authorized;
- Properly designed records;
- Controls to secure assets and accounting records;
- Segregation of incompatible duties;
- Periodic reconciliations;
- Periodic verifications; and
- Analytical review of accounting data for reasonableness.

***Procedures to ensure that transactions are properly authorized.*** Only designated individuals should be in a position to authorize transactions or to commit resources (issue purchase orders, make salary adjustments, authorize payments to vendors, approve overtime). Moreover, authorization, to be meaningful, must occur *in advance*. For example, the subsequent approval of a timesheet containing overtime would *not* be equivalent to authorization of the overtime, which should have occurred beforehand.

***Properly designed records.*** Records should be designed in accordance with the following principles:

- Standardized paper forms (purchase orders, invoices, receiving reports, vouchers) should be *sequentially prenumbered* so that individual documents can always be accounted for; in an electronic system, a unique identifier should be assigned to each transaction to allow for easy tracing;
- The accounting system should provide *automatic duplicates* (paper systems) or retain an image (electronic systems) of documents provided to outside parties (for example, receipts);
- The information system should systematically collect the data needed for *both* managerial purposes (for example, cost accounting) and financial reporting; and
- Electronic forms and processing should contain edit features to automatically notify the user that a §76 field was left blank or filled out incorrectly.

***Controls to secure assets and accounting records.*** Access to assets and accounting records should be on a strictly "as needed" basis. That is, individual employees should have *all* the access and *only* the access needed to perform their assigned tasks. Accounting systems should not allow records to be changed, adjusted, or reversed without a clear record of both the original entry and the later change.

Written policies and procedures should be in place to minimize the disruption that could result from a technology failure following a disaster *(disaster recovery)*. At a minimum, the Government Finance Officers Association (GFOA) recommends that these policies and procedures:

- Assign disaster recovery coordinators for each agency or department to form a disaster recovery team:
  - ▫ Define the responsibilities of team members;
  - ▫ Maintain a current list of team members and their contact information;
  - ▫ Establish procedures for assembling the team in the event of a disaster;
- Require the creation and preservation of back-up data:
  - ▫ Provide for the regular and timely back-up of electronic data;
  - ▫ Provide for the transportation and storage of back-up data off site;
  - ▫ Ensure the security of back-up data both during transport off site and during storage off site;
- Make provisions for the alternative processing of data following a disaster;
- Provide detailed instructions for restoring electronic files; and
- Establish guidelines for the immediate aftermath of a disaster.

A copy of these policies and procedures should be kept off site. Moreover, an entity should annually test its disaster recovery plan, and that test should involve the actual restoration and processing of data.

Often governments outsource services. If so, they should satisfy themselves concerning the adequacy of the provider's disaster recovery plan.[6] They also should obtain assurance regarding the provider's data security capabilities.

***Segregation of incompatible duties.*** The basic notion behind the segregation of incompatible duties is that no individual should be in the position to both commit and conceal an error or irregularity. That is, there should always be someone else to act as a check or balance. For example, fictitious "purchases" can be avoided by having someone other than the person who placed the order take receipt of the delivery.

Ideally, no single individual should be involved in more than one of the following functions for a given transaction:

- Authorization;
- Recordkeeping; and
- Custody of assets.

As already noted, for example, if one individual places an order (authorization), another individual should take receipt (custody of assets), and yet another record the transaction (recordkeeping), after confirming proper authorization (approved purchase order) and receipt (invoice and receiving report).

In larger organizations, incompatible duties often are assigned to different departments. In smaller §77 organizations, incompatible duties may be assigned to different individuals within the same department.

Once again, the cost of controls can never be allowed to exceed their benefits. Accordingly, very small entities sometimes have no choice but to find an alternative to the segregation of incompatible duties. One option is to periodically rotate duties within the organization. Another option is to use an outside service to perform certain functions (bank reconciliations prepared by an accounting firm). Still another approach is to use analytical review (discussed later) to identify potential problems.

***Periodic reconciliations.*** Control accounts in the general ledger *(accounts payable* and *accounts receivable)* are supported by subsidiary accounts (individual invoices). The amounts in both should be reconciled periodically. Control accounts also should be reconciled to independent outside records (reconciling the cash account to the bank statement).

***Periodic verifications.*** Most assets and liabilities have an existence apart from the accounting records. It is important that the two be compared periodically (physical inventory of capital assets).

***Analytical review of accounting data for reasonableness.*** It is easy to get lost in the details and miss the "big picture." Accordingly, there is no real substitute for stepping back periodically to evaluate the reasonableness of financial data. There are two facets to such *analytical review:*

- *Comparing financial data with other financial data*. The reasonableness of financial data often is best assessed by making comparisons with other financial data:

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# The Financial Statement Audit

The purpose of a financial statement audit, in both the public sector and the private sector, is to provide users of financial statements with reasonable assurance that they can rely upon those statements to make informed decisions. This chapter reviews certain key concepts that underlie any financial statement audit, with special emphasis on factors unique to the public sector.

## Responsibility for financial statements and the financial statement audit

Management, internal auditors, the governing body, the audit committee, and independent auditors all have a role to play in the production of audited financial statements.

### *Management/internal auditors*

Financial statements are the vehicle that *management* uses to give an accounting of its stewardship of the resources entrusted to its care. Stated differently, financial statements represent *management's* assertions regarding an entity's finances. Consequently, management always remains responsible for the financial statements, even if management engages the services of others to help meet that responsibility (just as taxpayers remain responsible for their tax returns, even if they have them prepared by a tax professional).

Management cannot responsibly make assertions about an entity's finances without having some reasonable basis for doing so. A comprehensive framework of internal control provides that reasonable basis.[1] Internal auditors can play a critical role in maintaining that framework.[2]

### *Governing body/audit committee*

The *governing body* is responsible for ensuring that management fulfills its obligations in regard to internal control and financial reporting. Typically, the governing body establishes an *audit committee* for that purpose. An audit committee helps the governing body meet its responsibility by:

1. See Chapter 42 for a discussion of internal control.
2. See Chapter 46 for a discussion of the work of internal auditors.